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Municipal Bankruptcy Authorization Under Chapter 9: A Call for Uniformity Among States

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MUNICIPAL BANKRUPTCY AUTHORIZATION UNDER CHAPTER 9: A CALL FOR UNIFORMITY AMONG STATES

*It is undeniable . . . that Chapter 9 is no longer of interest only to bankruptcy lawyers. As elected officials, county and municipal managers, budget officials, bond lawyers, financial advisors and capital markets address the problems now before them, and hopefully the plans for a prosperous future, all such participants should become increasingly knowledgeable of what can and cannot be accomplished in Chapter 9.*¹

I. INTRODUCTION

Could a municipality of this state file for bankruptcy under Chapter 9? If so, how would the bankruptcy process affect future borrowing costs and the value of the municipality's outstanding bonds? Would there be notable effects on the bond market as a whole? These questions, often posed to public finance attorneys, are increasingly relevant in light of the recent economic recession in the United States. Macroeconomic instability often trickles down to the local level, and municipal defaults have been shown to follow downturns in business cycles.²

Key factors for defaults include fluctuating land values, booms and busts in commodities, and improbable projections of the future.³ From a more analytical perspective, municipalities struggle to raise revenue in times of financial distress.⁴ This is due in part to diminishing property tax values, high unemployment, and declining manufacturing and construction activity, each resulting in decreased tax revenues for a city.⁵ Meanwhile, on the expense side, these same economic factors increase the per capita costs of operating a government.⁶ Finally, unexpected one-time expenses often arise in recessionary periods, creating fiscal challenges for municipalities that are

1. NAT'L ASS'N OF BOND LAWYERS, MUNICIPAL BANKRUPTCY: A GUIDE FOR PUBLIC FINANCE ATTORNEYS 103 (2011), *available at* http://www.nabl.org/uploads/cms/documents/municipal_bankruptcy_a_guide_for_public_finance_attorneys.pdf.

2. Cate Long, *Would the real default rate stand up?*, THOMSON REUTERS, Apr. 19, 2011, <http://blogs.reuters.com/muniland/2011/04/19/would-the-real-default-rate-stand-up/>.

3. NAT'L ASS'N OF BOND LAWYERS, *supra* note 1, at 5.

4. *Id.*

5. *Id.*

6. *Id.* at 6.

unable to quickly raise revenue.⁷ Such expenses include those that follow from failed projects, legal judgments against the city, and environmental remediation obligations.⁸

When a municipality finds itself in financial peril due to these economic hardships, it may consider Chapter 9 bankruptcy its most efficient solution. Perhaps the most recent and noteworthy example is the City of Detroit filing for municipal bankruptcy on July 18, 2013⁹ in what Michigan Governor Richard Snyder deemed “the only reasonable alternative . . . available.”¹⁰ Detroit’s filing marked the largest municipal bankruptcy since the creation of the Chapter 9 law in 1938,¹¹ with an estimated \$18 billion in outstanding debt.¹² Many of the city’s financial difficulties correspond to those outlined above. Specifically, Detroit’s unemployment rate has almost tripled since 2000, its roughly 78,000 abandoned structures reflect a lack of manufacturing and construction activity, and Governor Snyder attributed the city’s inability to meet creditor obligations to “a decreasing tax base.”¹³

This comment will first consider a municipality’s ability to utilize the Chapter 9 bankruptcy law. Particular emphasis will be given to Tenth Amendment limitations and the statutory eligibility requirements. It will then describe notable Chapter 9 legal cases, outline the benefits and ill effects of filing for municipal bankruptcy, and analyze the treatment of bonds in Chapter 9 proceedings. Finally, the comment will argue that states should uniformly authorize Chapter 9 bankruptcies—both expressly in their statutes and without

7. *Id.*

8. *Id.*

9. *What Detroit’s Bankruptcy Means for Muni Bonds*, CHARLES SCHWAB ON INVESTING, Winter 2013, available at http://www.schwab.com/public/file/P-6479089/On_Investing_Full_PDF.pdf.

10. John Bringardner, *Detroit Files For Chapter 9, Largest Ever Municipal Bankruptcy*, FORBES, July 18, 2013, <http://www.forbes.com/sites/spleverage/2013/07/18/detroit-files-for-chapter-9-largest-ever-municipal-bankruptcy/>.

11. Juliet M. Moringiello, *Goals and Governance in Municipal Bankruptcy*, 71 WASH. & LEE L. REV. 403, 403 (2014). The first municipal debt provisions were actually enacted in 1934 in response to an estimated 1,000 municipalities defaulting on their bonds during the Great Depression. The United States Supreme Court found the legislation unconstitutional for infringing on the sovereign powers of the states. Revised legislation was then enacted in 1937 and upheld by the Supreme Court in *United States v. Bekins* (1938). JAMES E. SPIOTTO, CHAPMAN AND CUTLER LLP, PRIMER ON MUNICIPAL DEBT ADJUSTMENT 4–5 (2012), available at http://www.afgi.org/resources/Bankruptcy_Primer.pdf.

12. Michael Corkery & Matthew Dolan, *Detroit Bankruptcy Likely to Spark a Pension Brawl: Filing Will be a Test Case of How Far a City Can Go in Shredding Retiree Costs*, WALL ST. J. (ONLINE), July 19, 2013, <http://www.wsj.com/articles/SB10001424127887324263404578616204128866568>.

13. Bringardner, *supra* note 10.

limitations or preconditions. This change would help create uniformity, promote predictability, and stabilize the municipal bond market.

II. TENTH AMENDMENT CONSIDERATIONS

In accordance with the federal Constitution, Congress holds the power to establish “uniform Laws on the subject of Bankruptcies throughout the United States.”¹⁴ This authority, however, is limited by the sovereign powers of the states.¹⁵ In particular, the Tenth Amendment provides that “[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are preserved to the States respectively, or to the people.”¹⁶ In enacting Chapter 9, Congress was well aware of the risk that broad municipal bankruptcy powers could interfere with the right of states to control their internal affairs in violation of this amendment.¹⁷ After all, a municipality is a mere subdivision or instrumentality of the state in which it is located.¹⁸ As a result, the Bankruptcy Code places significant restraints on the powers of a federal bankruptcy court to interfere with the operations of a state-controlled municipality in Chapter 9 proceedings.¹⁹

One such restraint can be found in 11 U.S.C. § 904 of the Bankruptcy Code.²⁰ This section forbids the bankruptcy court from interfering with a Chapter 9 municipality’s ability to use its property, raise taxes, or make expenditures without its consent.²¹ Additionally, the bankruptcy judge is restricted from forcing the municipality to sell its assets to satisfy a secured creditor’s lien or appointing a trustee to assume management powers over the

14. U.S. CONST. art. I, § 8, cl. 4.

15. Francisco Vazquez, *Examining Chapter 9 Municipal Bankruptcy Cases*, in CHAPTER 9 BANKRUPTCY STRATEGIES: LEADING LAWYERS ON NAVIGATING THE CHAPTER 9 FILING PROCESS, COUNSELING MUNICIPALITIES, AND ANALYZING RECENT TRENDS AND CASES 173, 176–77 (2011).

16. U.S. CONST. amend. X.

17. Vazquez, *supra* note 15, at 177.

18. Peter J. Benvenutti & Joseph M. Witalec, *State Law Authorization for a Chapter 9 Filing*, in CHAPTER 9 BANKRUPTCY STRATEGIES: LEADING LAWYERS ON NAVIGATING THE CHAPTER 9 FILING PROCESS, COUNSELING MUNICIPALITIES, AND ANALYZING RECENT TRENDS AND CASES 35, 37 (2011).

19. Leon R. Barson & Francis J. Lawall, *Chapter 9 Bankruptcy: Restructuring Municipalities in Financial Distress*, in CHAPTER 9 BANKRUPTCY STRATEGIES: LEADING LAWYERS ON NAVIGATING THE CHAPTER 9 FILING PROCESS, COUNSELING MUNICIPALITIES, AND ANALYZING RECENT TRENDS AND CASES 7, 16–17 (2011).

20. John J. Rapisardi et al., *Chapter 9: A Big Stick, Rarely Used*, in CHAPTER 9 BANKRUPTCY STRATEGIES: LEADING LAWYERS ON NAVIGATING THE CHAPTER 9 FILING PROCESS, COUNSELING MUNICIPALITIES, AND ANALYZING RECENT TRENDS AND CASES 153, 157 (2011).

21. 11 U.S.C. § 904 (2006).

municipality.²² Rather, a Chapter 9 municipality retains total control over its own operations and affairs.²³ It is not required to seek court approval before using, leasing, or even selling property outside the ordinary course of business.²⁴ Thus a municipality can, in its independent discretion, choose to make any transfer or pay any claims, including those arising before the petition for Chapter 9 bankruptcy.²⁵

Consequently, the bankruptcy judge's involvement is severely limited.²⁶ His or her primary duties are to determine the filing municipality's Chapter 9 eligibility, oversee the handling of executory contracts, and approve or deny the proposed plan of adjustment.²⁷ As such, it can be argued that most of the court's role only occurs at the front and back ends of the proceedings.²⁸ Accordingly, Chapter 9 debtors typically conduct their affairs without obtaining any form of prior approval from the bankruptcy court.²⁹ The municipalities, therefore, seem to be subjected to far less court oversight than their counterparts in the corporate sector—namely Chapter 11 debtors.³⁰ This prevents creditors from influencing municipal affairs during Chapter 9 proceedings or gaining any significant leverage in general.³¹

Congress' recognition of Tenth Amendment concerns in municipal bankruptcies has also resulted in strict eligibility requirements for Chapter 9 relief.³² Although a more in-depth analysis of eligibility will be provided in the next section, one requirement in particular is closely linked to the preservation of state power. Since state control is protected by the Tenth Amendment and consent is necessary for one of its municipalities to file for bankruptcy, 11 U.S.C. § 109(c) requires specific authorization by the state for Chapter 9 proceedings to commence.³³ The state authorization requirement serves only a threshold purpose, as once it and the other eligibility requirements are satisfied, Chapter 9 in its entirety applies to the bankruptcy case without restrictions from state law.³⁴ As the *In re City of Vallejo* court explained, the Bankruptcy

22. Barson & Lawall, *supra* note 19, at 17.

23. Vazquez, *supra* note 15, at 177.

24. *Id.*

25. *Id.*; cf. 11 U.S.C. § 363 (2006) (imposing limitations on use, sale, and lease of property by a trustee in bankruptcy). § 901 makes § 363 inapplicable in a Chapter 9 case. Vazquez, *supra* note 15, at 177.

26. Barson & Lawall, *supra* note 19, at 17.

27. *Id.*

28. *Id.*

29. Rapisardi et al., *supra* note 20, at 157.

30. *Id.*

31. *Id.*

32. Benvenuti & Witalec, *supra* note 18, at 36–37.

33. 11 U.S.C. § 109(c) (2006).

34. Benvenuti & Witalec, *supra* note 18, at 37.

Code affords states the opportunity to “act as gatekeepers to their municipalities’ access to relief” under the code.³⁵ However, once a state provides the necessary authorization, it “must accept Chapter 9 in its totality” and essentially “declares that the benefits of Chapter 9 are more important than state control over its municipalities.”³⁶

III. STATUTORY ELIGIBILITY REQUIREMENTS FOR CHAPTER 9 BANKRUPTCY

Title 11 § 109 of the United States Code sets out the criteria for qualifying as a debtor under various chapters of the title.³⁷ Subsection (c) describes which entities may constitute debtors for purposes of Chapter 9 and establishes five eligibility requirements.³⁸ These are threshold elements that must all be satisfied in order to pursue a Chapter 9 bankruptcy.³⁹ Bankruptcy courts are tasked with scrutinizing these petitions and thus, over time, have begun to adjudicate the meaning and construction of the 11 U.S.C. § 109(c) eligibility requirements.⁴⁰

First, the debtor must be a municipality.⁴¹ 11 U.S.C. § 101(40) defines a municipality as a “political subdivision or public agency or instrumentality of a State.”⁴² A political subdivision typically includes a county, parish, city, town, village, borough, or township.⁴³ Meanwhile, a public agency or instrumentality generally refers to an entity organized for the purpose of constructing, maintaining, and operating revenue-producing enterprises.⁴⁴ The source of the revenue may range from taxes to income-producing property.⁴⁵ As a result,

35. *In re City of Vallejo*, 403 B.R. 72, 76 (Bankr. E.D. Cal. 2009).

36. *Id.*

37. 11 U.S.C. § 109 (2006).

38. 11 U.S.C. § 109(c) (2006).

39. Seena Foster, Annotation, *Eligibility for Chapter 9 Bankruptcy Relief, Applicable to Municipalities, Pursuant to 11 U.S.C.A. § 109(c)*, 57 A.L.R. FED. 2d 121 (2011).

40. *Id.*

41. 11 U.S.C. § 109(c)(1) (2006).

42. 11 U.S.C. § 101(40) (2006).

43. See *In re County of Orange*, 183 B.R. 594, 601, 601 n.16 (Bankr. C.D. Cal. 1995) (noting that “case law offers little guidance” in properly defining “municipality”); see also *In re N.Y.C. Off-Track Betting Corp.*, 427 B.R. 256, 265 (Bankr. S.D.N.Y. 2010) (noting that the legislative history “does not offer any assistance in determining the scope” of the term).

44. See *In re Las Vegas Monorail Co.*, 429 B.R. 770, 795 (Bankr. D. Nev. 2010) (reasoning that whether an entity is an instrumentality depends on “the extent to which the entity has traditional governmental attributes or engages in traditional governmental functions, the extent to which the State controls the entity’s operations, . . . and the extent to which the State itself categorizes the entity as a municipality or instrumentality”); see also *In re County of Orange*, 183 B.R. at 602–03 (discussing types of entities that qualify as public agencies or instrumentalities of the state).

45. Vazquez, *supra* note 15, at 183.

hospitals, school districts, and highway authorities are public agencies or instrumentalities and may be eligible to qualify as Chapter 9 debtors.⁴⁶

The municipality must also demonstrate that it is insolvent.⁴⁷ Under the Bankruptcy Code, insolvency is established if the municipality is either generally not paying or entirely unable to pay its debts as they become due.⁴⁸ Courts typically analyze a municipality's insolvency as of the date of the Chapter 9 filing to determine its eligibility for Chapter 9 relief.⁴⁹ The first formulation of insolvency would generally not be satisfied upon nonpayment of undisputed amounts that a municipality can pay, nonpayment of debts that are not due, or nonpayment in bad faith.⁵⁰ On the other hand, the second formulation requires a prospective analysis and a showing of a future inability to pay, which often is demonstrated by submitting projections or a budget to the court.⁵¹

In addition, only a municipality that "desires to effect a plan to adjust [its] debts" may be a debtor under Chapter 9.⁵² No bright-line test exists for this determination, as courts instead apply a subjective test and generally consider direct, circumstantial, or other evidence indicative of the municipality's intent.⁵³ If the court concludes that the municipality filed in order to delay or evade its creditors, it is not entitled to relief under Chapter 9.⁵⁴

Next, the municipality must satisfy one of the four alternatives set forth in § 109(c)(5) by demonstrating that it

(A) has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter; (B) has negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter; (C) is unable to negotiate with creditors because such negotiation is impracticable; or (D) reasonably

46. *Id.*

47. 11 U.S.C. § 109(c)(3) (2006).

48. 11 U.S.C. § 101(32)(C) (2006).

49. *In re Slocum Lake Drainage Dist. of Lake City*, 336 B.R. 387, 391 (Bankr. N.D. Ill. 2006) (laying out the principle that "[e]ligibility is properly measured at the time the petition is filed, not at some later or indeterminable future date").

50. *In re Town of Westlake*, 211 B.R. 860, 864 (Bankr. N.D. Tex. 1997); *In re Hamilton Creek Metro. Dist.*, 143 F.3d 1381, 1385 (10th Cir. 1998).

51. *In re Pierce Cnty. Hous. Auth.*, 414 B.R. 702, 710–11 (Bankr. W.D. Wash. 2009). This is a cash flow, not a budget deficit, analysis. *Id.* at 711.

52. 11 U.S.C. § 109(c)(4) (2006).

53. *In re City of Vallejo*, 408 B.R. 280, 295 (B.A.P. 9th Cir. 2009).

54. *Id.*

believes that a creditor may attempt to obtain a transfer that is avoidable under section 547 of this title.⁵⁵

Perhaps the most contested eligibility requirement is § 109(c)(2), which requires that the municipality be “specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under [Chapter 9].”⁵⁶ This element demands further consideration, as states have yet to reach a consensus on whether or not to allow their municipalities to file for Chapter 9 bankruptcy. Moreover, there are differing limitations and preconditions among those states that do provide authorization.

IV. THE STATE AUTHORIZATION REQUIREMENT

Prior to 1994, § 109(c)(2) required only that municipalities be “generally authorized” (emphasis added) to file for Chapter 9 relief.⁵⁷ Most courts interpreted this phrase broadly such that the state did not need to expressly grant municipalities the power to file.⁵⁸ Rather, the authority to file could be implied from the general powers granted to a municipality by the state.⁵⁹ However, other courts refused to imply or infer such power and instead mandated express authorization.⁶⁰ Such inconsistency in the interpretation of the law yielded unpredictable results across the country.

In 1994, Congress responded by amending § 109(c) to replace the “generally authorized” language with the phrase, “specifically authorized” (emphasis added).⁶¹ Scholars and practitioners believe this amendment makes clear that, to be effective, the state statute must expressly articulate a municipality’s power to file for bankruptcy, as this authority can no longer be

55. 11 U.S.C. § 109(c)(5) (2006).

56. 11 U.S.C. § 109(c)(2) (2006).

57. Benvenuti & Witalec, *supra* note 18, at 38.

58. *Id.*

59. *Id.*; see also *In re Pleasant View Util. Dist. of Chatham Cnty., Tenn.*, 24 B.R. 632, 638 (Bankr. M.D. Tenn. 1982) (finding that “the term ‘generally authorized’ as used in § 109(c) means only that the state should give some indication that the municipality has the necessary power to seek relief under the federal bankruptcy law”).

60. Daniel J. Freyberg, Note, *Municipal Bankruptcy and Express State Authorization to be a Chapter 9 Debtor: Current State Approaches to Municipal Insolvency-And What Will States Do Now?*, 23 OHIO N.U. L. REV. 1001, 1007 (1997). For example, one court concluded that affirmative action from the state was necessary for authorization. *In re Carroll Twp. Auth.*, 119 B.R. 61, 63 (Bankr. W.D. Penn. 1990).

61. 11 U.S.C. § 109(c) (2006).

implied from general powers.⁶² According to the bankruptcy court in *In re County of Orange*, the consensus is that state law must provide authority that is “exact, plain, and direct with well-defined limits so that nothing is left to inference or implication.”⁶³ Thus far, no court has directly decided whether the state authorization statute must specifically reference Chapter 9 or one of its predecessors to meet this eligibility requirement.⁶⁴

States have failed to reach any type of uniformity in providing the specific authorization required for Chapter 9 filings. According to James Spiotto, a bankruptcy specialist with the Chicago law firm of Chapman and Cutler LLP, fifteen states have laws granting their municipalities the right to file for Chapter 9 protection on their own.⁶⁵ Those states are Alabama, Arizona, Arkansas, California, Idaho, Kentucky, Minnesota, Missouri, Montana, Nebraska, New York, Oklahoma, South Carolina, Texas, and Washington.⁶⁶ While Georgia expressly forbids municipalities from filing for bankruptcy under any circumstances, Spiotto explains that the remaining states all want to remain in the process in various capacities.⁶⁷

Kenneth E. Noble and Kevin M. Baum of Katten Muchin Rosenman LLP break down the various levels of state authorization differently.⁶⁸ They find that twelve states specifically authorize Chapter 9 filings, while twelve others permit bankruptcy filings only after further action is taken by a state, official, or other entity.⁶⁹ Additionally, three other states authorize a limited subset of

62. Benvenuti & Witalec, *supra* note 18, at 39. Courts have reached a similar conclusion. *In re Slocum Lake Drainage Dist. of Lake City*, 336 B.R. 387, 390 (Bankr. N.D. Ill. 2006) (observing that “specific authorization by a state is necessary . . .”).

63. *In re County of Orange*, 183 B.R. 594, 604 (Bankr. C.D. Cal. 1995).

64. Benvenuti & Witalec, *supra* note 18, at 39.

65. John Gramlich, *Municipal bankruptcy explained: What it means to file for Chapter 9*, NEWS HERALD, July 20, 2013, <http://www.thenewsherald.com/articles/2013/07/20/news/doc51eaf545c13fd728275659.txt?viewmode=fullstory>. Chapman and Cutler LLP has focused its practice on finance since its founding in 1913 and contains a “Bankruptcy, Restructuring and Workouts” practice area consisting of over twenty-five attorneys. CHAPMAN AND CUTLER LLP, <http://www.chapman.com> (last visited Feb. 19, 2014).

66. Gramlich, *supra* note 65.

67. *Id.*

68. Kenneth E. Noble & Kevin M. Baum, *Municipal bankruptcies: an overview and recent history of Chapter 9 of the Bankruptcy Code*, LEXOLOGY, July 23, 2013, <http://www.lexology.com/library/detail.aspx?g=c47c30f7-e91f-4398-82f3-f0ce5d2ef704>. Katten Muchin Rosenman LLP has a renowned “Insolvency and Restructuring” group consisting of over twenty attorneys. *Insolvency and Restructuring*, KATTEN MUCHIN ROSENMAN LLP, <http://www.kattenlaw.com/insolvencyandrestructuring#overview> (last visited Feb. 19, 2014).

69. Noble & Baum, *supra* note 68.

municipalities to file for bankruptcy.⁷⁰ The remaining twenty-three states do not authorize municipal bankruptcy filings.⁷¹

Cory Eucalitto, Kristen De Pena, and Shannan Younger created the following map to illustrate each state's position on authorization as of February 2013:⁷²



70. *Id.*

71. *Id.*

72. CORY EUCALITTO ET AL., STATE BUDGET SOLUTIONS, MUNICIPAL BANKRUPTCY: AN OVERVIEW FOR LOCAL OFFICIALS 7 (2013), available at http://www.statebudgetsolutions.org/doclib/20130301_SBSBankruptcyReport.pdf.

A. *States Without Necessary Chapter 9 Authorization*

The typology used in the map distinguishes between states prohibiting municipalities from filing for bankruptcies and states that merely choose not to enact a statute specifically authorizing Chapter 9 filings.⁷³ However, given the fact that explicit permission from the state is now believed necessary to satisfy the § 109(c)(2) specific authorization requirement,⁷⁴ the states that are silent on municipality bankruptcy effectively prohibit Chapter 9 filings as well. Therefore, the two categories can be combined into states that do not permit their municipalities to engage in the Chapter 9 process. These states are Alaska, Delaware, Georgia, Hawaii, Indiana, Iowa, Kansas, Maine, Maryland, Massachusetts, Mississippi, New Hampshire, New Mexico, Nevada, North Dakota, South Dakota, Tennessee, Utah, Vermont, Virginia, West Virginia, Wisconsin, and Wyoming.⁷⁵

B. *States With Limited Chapter 9 Authorization*

Meanwhile, Colorado, Illinois, and Oregon provide specific authorization but in a limited manner.⁷⁶ For example, in Illinois, only municipalities with less than 25,000 residents are specifically authorized to file under Chapter 9.⁷⁷ However, this authorization is only possible after compliance with a lengthy and cumbersome pre-filing process.⁷⁸ On the other hand, cities with populations exceeding 25,000 must utilize the Financially Distressed City Law, which provides for a form of receivership proceeding only for “financially distressed” cities as labeled by the state.⁷⁹

73. *Id.*

74. Some scholars, however, argue that despite the shift from “general” to “specific” authorization, ambiguity remains as to whether explicit statutory authorization is actually needed for municipalities to file. Christopher Smith, *Provisions for Access to Chapter 9 Bankruptcy: Their Flaws and the Inadequacy of Past Reforms*, 14 BANKR. DEV. J. 497, 514 (1998).

75. *Id.*

76. *Id.*

77. David Warfield, *Could a Detroit-style bankruptcy happen here?*, ST. LOUIS BUS. J., Sept. 6, 2013, <http://www.bizjournals.com/stlouis/print-edition/2013/09/06/could-a-detroit-style-bankruptcy.html?page=all>.

78. *Id.*

79. Mark Glennon, *Bankruptcy is not an option for Illinois cities or other units under current law*, WIREPOINTS ILL. NEWS, July 29, 2013, <http://www.wirepoints.com/dont-count-on-a-bankruptcy-proceeding-to-fix-illinois-government-at-any-level/>. Therefore, due to their size, municipalities such as Chicago and Cook County do not have the specific authorization necessary for Chapter 9 eligibility. *Id.*

C. States With Preconditions to Chapter 9 Filings

The following states authorize Chapter 9 bankruptcies but impose preconditions with which the municipalities must first comply before filing for relief: California, Connecticut, Florida, Kentucky, Louisiana, Michigan, New Jersey, New York, North Carolina, Ohio, Pennsylvania, and Rhode Island.⁸⁰ California provides an excellent illustration of the principle that states serve a Chapter 9 gatekeeping function by virtue of the § 109(c)(2) specific authorization requirement and corresponding Tenth Amendment considerations.⁸¹ As the court in *In re City of Stockton, Cal.* explained, California chose to engineer certain parameters of its gate through California Government Code § 53760.⁸² It implemented mandatory preconditions a municipality must partake in before receiving authorization to become a Chapter 9 debtor.⁸³ In particular, the municipality must first either engage in a neutral evaluation process or have a fiscal emergency declared by its governing board.⁸⁴ This principle is also well evidenced by states like Michigan⁸⁵ and Rhode Island,⁸⁶ among others.

D. States Providing Unfettered Access to Chapter 9

The relevant Missouri statute provides a standard example of the specific authorization necessary for Chapter 9 filing free from any limitations or preconditions:

The consent of the state is hereby granted to, and all appropriate powers are hereby conferred upon, any municipality or political subdivision organized under the laws of the state to institute any appropriate action authorized by any act of the Congress of the United States relating to bankruptcy on the part of any municipality or political subdivision.⁸⁷

80. EUCALITTO ET AL., *supra* note 72, at 7.

81. *In re City of Stockton, California*, 475 B.R. 720, 727 (Bankr. E.D. Cal. 2012).

82. *Id.*

83. *Id.*

84. *Id.*

85. Before Detroit's filing in 2013, investors considered Michigan a state that took measures for its municipalities to avoid Chapter 9, as multiple requirements were in place before filing a petition. KRISTEN DEJONG & BETH DOUGHERTY, NUVEEN ASSET MGMT., MUNICIPAL BANKRUPTCY: A PRIMER ON CHAPTER 9, at 2 (2013), *available at* <http://www.nuveen.com/Home/Documents/Viewer.aspx?fileId=48362>.

86. In May 2010, Rhode Island passed legislation that established the state's intervention role in financially distressed municipalities. A three-stage intervention process is now in place before authorization is given for Chapter 9 relief. *Id.* at 3.

87. MO. ANN. STAT. § 427.100 (West 2010).

States that offer their municipalities similar unfettered access to Chapter 9 relief include Alabama, Arizona, Arkansas, Idaho, Minnesota, Missouri, Montana, Nebraska, Oklahoma, South Carolina, Texas, and Washington.⁸⁸

V. NOTEWORTHY CHAPTER 9 BANKRUPTCY CASES

Although little case law exists in the area of Chapter 9 bankruptcy filings, a few notable court decisions illustrate some of the potential issues that may arise in a municipality's attempt to meet the statutory eligibility requirements. The cases below address specifically the issue of state authorization.

In *In re County of Orange*, the treasurer of Orange County, California combined funds into a general investment pool, bond investment pool, and specific investment account that collectively filed a Chapter 9 petition.⁸⁹ The court discussed the specific authorization requirement and ultimately concluded that it was not satisfied.⁹⁰ The case was decided in 1995, so this bankruptcy court was one of the first to interpret the revised language of § 109(c)(2).⁹¹ The court reasoned:

Despite the need for specificity, I see no reason why the state authorization can not be by specific category. For example, the statute could authorize all 'municipalities' as defined in the Code to file bankruptcy. As previously noted, the Code defines municipalities by categories. The state statute could also name the specific entities within certain categories. That was the approach previously taken in the 1937 Act by § 81. In either case, the authorization would appear to be sufficiently specific.⁹²

In regard to California's authorization statute, the court noted that it specifically referenced § 81, a "laundry list of public entities that are authorized to file bankruptcy."⁹³ Since § 81 did not refer to an investment fund or any similar entity, the court found a lack of specific authorization to file for Chapter 9 relief.⁹⁴

The bankruptcy court in *In re New York City Off-Track Betting Corp.* engaged in a slightly different analysis of the state authorization requirement.⁹⁵ The entity that filed for Chapter 9 relief was the New York City Off-Track Betting Corporation (NYC OTB).⁹⁶ NYC OTB was a public-benefit

88. EUCALITTO ET AL., *supra* note 72, at 7.

89. *In re County of Orange*, 183 B.R. 594, 596 (Bankr. C.D. Cal. 1995).

90. *Id.* at 605.

91. *Id.* at 603.

92. *Id.* at 604-05.

93. *Id.* at 605.

94. *Id.*

95. *In re N.Y.C. Off-Track Betting Corp.*, 427 B.R. 256 (Bankr. S.D.N.Y. 2010)

96. *Id.* at 261.

corporation that operated a system of gambling in which bets placed on a race were pooled and then paid to those holding winning tickets.⁹⁷ It was created by the New York legislature in 1970 in order to raise revenues for the state and its municipalities as well as to combat the presence of organized crime in horserace gambling.⁹⁸ Facing severe financial hardship, NYC OTB filed for Chapter 9 bankruptcy in late 2009.⁹⁹

The court concluded that NYC OTB had sufficient authorization from New York to file for Chapter 9 protection.¹⁰⁰ Since the New York legislature had not passed a statute explicitly granting NYC OTB the power to file for Chapter 9 bankruptcy, the court instead looked to the governor's executive order that specifically authorized a filing by the corporation.¹⁰¹ In finding this order sufficient for purposes of § 109(c)(2), the court deemed the governor's issuance a direct and unambiguous order explicitly authorizing NYC OTB to file for bankruptcy.¹⁰² In fact, it held that the executive order followed Congress' instructions precisely, as the statute plainly states that "a governmental officer . . . empowered by State law" may specifically authorize a municipality.¹⁰³

Most recently, a bankruptcy court in the Eastern District of Michigan declared the City of Detroit in compliance with the § 109(c) statutory requirements and thus eligible for Chapter 9 protection.¹⁰⁴ Michigan is one of the twelve states imposing certain preconditions on its municipalities before authorizing a filing under Chapter 9. However, in Detroit's case, the court held that the city received the necessary § 109(c)(2) specific authorization through a proper governmental officer.¹⁰⁵ Namely, Emergency Manager Kevyn Orr

97. *Id.*

98. *Id.*

99. *Id.* at 263.

100. *Id.* at 271.

101. *In re N.Y.C. Off-Track Betting Corp.*, 427 B.R. at 267.

102. *Id.* at 267–68.

103. *Id.* at 268. The court further noted that this reading of the statute in no way frustrates Congress's intent to require specific authorization for a municipality to file for Chapter 9 protection. The court stated Congress was perfectly capable of revising § 109(c)(2) if it desired to circumscribe the power of government officials to provide the specific authorization to certain municipalities. *Id.*

104. *In re City of Detroit*, Michigan, No. 13-53846, 2013 WL 6331931, at *2 (Bankr. E.D. Mich. Dec. 5, 2013). From the bench, U.S. Bankruptcy Judge Steven Rhodes stated, "This once proud and prosperous city can't pay its debts. It's insolvent. It's eligible for bankruptcy. At the same time, it also has an opportunity for a fresh start." Reid Wilson, *Judge declares Detroit eligible for Chapter 9 bankruptcy*, WASH. POST, Dec. 3, 2013, <http://www.washingtonpost.com/blogs/govbeat/wp/2013/12/03/judge-declares-detroit-eligible-for-chapter-9-bankruptcy/>.

105. *In re City of Detroit*, Mich., 2013 WL 6331931, at *45.

issued a written order directing Detroit to file for bankruptcy after obtaining approval by the governor.¹⁰⁶

This process was accomplished through Michigan's Local Financial Stability and Choice Act, which allows the governor to declare a state of financial emergency and appoint an emergency manager with broad powers, including bankruptcy authorization.¹⁰⁷ Although this act was previously declared unconstitutional by a Michigan state court due to its lack of protection of accrued pension benefits, the bankruptcy court reasoned that the impairment is expressly permitted during bankruptcy proceedings.¹⁰⁸ Therefore, state authorization through the act was proper.¹⁰⁹

Now that the city's Chapter 9 petition is valid, Detroit can partake in the potentially lengthy bankruptcy process. The details of the city's ultimate readjustment plan are yet to be determined, but regardless of the outcome, "the Detroit case will influence the municipal bond markets and public pension industry for years to come."¹¹⁰

VI. ADVANTAGES AND DISADVANTAGES OF CHAPTER 9 PROTECTION

Although the case law demonstrates that issues can arise with any of the eligibility requirements, perhaps the most uncertainty lies with the specific authorization inquiry given the varying approaches among states. In determining whether or not to impose any limitations or preconditions, states should consider the advantages and disadvantages of allowing municipalities to ultimately partake in Chapter 9 bankruptcy proceedings.

From the municipality's perspective, a key advantage of Chapter 9 is that the filing of a bankruptcy petition invokes an automatic stay that remains in effect for the duration of the case.¹¹¹ This is essentially an injunction against most actions that could otherwise be taken against the municipality by creditors and others.¹¹² Significantly, the automatic stay extends to elected officials and all inhabitants of the municipality.¹¹³ Thus, even if the municipality or other protected persons take or omit actions related to claims against the municipality that would otherwise subject them to sanctions or

106. *Id.*

107. MICH. COMP. LAWS § 141.1541–.1575 (2013).

108. J. Robert Stoll et al., *Detroit, Michigan, Eligible to File Chapter 9 Bankruptcy*, MAYER BROWN LLP, December 13, 2013, <http://www.mayerbrown.com/Detroit-Michigan-Eligible-to-File-Chapter-9-Bankruptcy-12-13-2013/>.

109. *Id.*

110. Warfield, *supra* note 77.

111. Barson & Lawall, *supra* note 19, at 9.

112. *Id.*

113. 11 U.S.C. § 922(a)(1) (2006).

liability, those claims require prior permission from the bankruptcy court in order to proceed.¹¹⁴

Another advantage of Chapter 9 bankruptcy is breathing room for the distressed municipality, which is afforded much-needed time to develop and negotiate a debt adjustment plan.¹¹⁵ Creditor, labor, and most other disputes are all addressed in one forum, and the automatic stay gives the municipality the chance to focus on restructuring its outstanding obligations to creditors.¹¹⁶ This breathing space is crucial for the municipality, as raising new revenues, renegotiating contracts, and restructuring debts are all time-consuming endeavors.¹¹⁷

In addition, municipalities filing under Chapter 9 benefit from limited bankruptcy court involvement.¹¹⁸ As previously mentioned, the court cannot interfere with the general operations of the local government and does not have the power to appoint a trustee to take control of the municipality or call for its liquidation.¹¹⁹ Viewed from a different perspective, the municipality benefits from access to the bankruptcy judges, who are often experts in financial restructuring, negotiations, and complex debtor-creditor and intercreditor disputes.¹²⁰ As one commentator suggests, “the value of a highly qualified and experienced judge in helping the stakeholders get to a solution should not be underestimated.”¹²¹

A final advantage is the municipality’s ability to adjust its debts and other obligations.¹²² If a plan of adjustment is ultimately confirmed by the bankruptcy court in a Chapter 9 case, it may provide that unpaid claims of creditors be reduced, extended and restructured, or both.¹²³ Although there are numerous limitations to this ability, the plan can provide a fresh start to the municipality and allow it to achieve long-term financial stability by deferring or reducing past obligations.¹²⁴

114. JOHN KNOX & MARC LEVINSON, ORRICK, HERRINGTON & SUTCLIFFE LLP, *MUNICIPAL BANKRUPTCY: AVOIDING AND USING CHAPTER 9 IN TIMES OF FISCAL STRESS* 9 (2009), available at <http://www.orrick.com/Events-and-Publications/Documents/1736.pdf>.

115. Barson & Lawall, *supra* note 19, at 9.

116. *Id.*

117. KNOX & LEVINSON, *supra* note 114, at 10.

118. Barson & Lawall, *supra* note 19, at 10.

119. *Id.*

120. KNOX & LEVINSON, *supra* note 114, at 10.

121. *Id.*

122. *Id.*

123. *Id.*

124. *Id.* at 10–11.

Shifting now to the disadvantages, pursuing a Chapter 9 bankruptcy can be extremely costly.¹²⁵ Legal and financial consulting fees can be steep, and this represents money that cannot instead be spent on solving the underlying financial problem.¹²⁶ There is also an opportunity cost involved, as valuable staff time is taken away from solving core financial problems and is instead directed toward managing and responding to the demands of the bankruptcy case itself.¹²⁷ The distraction of dealing with a Chapter 9 case can severely interfere with the staff's ability to keep the municipality functioning.¹²⁸

There is also a social cost to filing—the stigma attached to bankruptcy for both the municipality and its residents.¹²⁹ The stigma may harm the self-esteem of the citizens and have an adverse impact on the overall business climate in the community.¹³⁰ New businesses may be reluctant to relocate to the municipality, real estate sales may fall, and general economic conditions in the area may falter.¹³¹ This stigma could linger long after the municipality emerges from bankruptcy.¹³²

Thus far, few municipalities have filed for Chapter 9 bankruptcy and had their cases reach litigation.¹³³ Therefore, there is little precedent on the behavior of judges in a municipal bankruptcy.¹³⁴ As one commentator warns, “[m]unicipalities that file [under Chapter 9] may be exposing themselves to risks from adverse judicial decisions.”¹³⁵ As discussed earlier, adjustment plans must be confirmed by the court as well.

Finally, a major disadvantage to filing for a Chapter 9 bankruptcy is the reaction of credit markets.¹³⁶ Municipalities seeking bankruptcy relief should expect a negative effect on their credit ratings, at least in the short term.¹³⁷ The credit stigma may last for years, especially if bondholders are not repaid in full.¹³⁸ Intense scrutiny from the municipality's creditors and rating agencies

125. *Id.* at 12.

126. KNOX & LEVINSON, *supra* note 114, at 12.

127. *Id.*

128. *Id.*

129. Barson & Lawall, *supra* note 19, at 11.

130. KNOX & LEVINSON, *supra* note 114, at 12.

131. *Id.*

132. *Id.*

133. ARTHUR R. O'KEEFE, BYN MELLON WEALTH MGMT., MUNI BOND DEFAULTS, BANKRUPTCIES AND BONDHOLDER PROTECTIONS 2 (2013), available at http://www.bnymellonwealthmanagement.com/Resources/documents/PerspectivesDocs/Muni_Bond_Defaults.pdf.

134. *Id.*

135. *Id.*

136. Barson & Lawall, *supra* note 19, at 11.

137. *Id.*

138. KNOX & LEVINSON, *supra* note 114, at 11.

should also be expected.¹³⁹ It is recommended that the municipality provide timely and transparent information about its financial condition in order to best position itself to restore its credit ratings going forward.¹⁴⁰

VII. MUNICIPAL BOND TREATMENT IN CHAPTER 9 BANKRUPTCIES

States should also consider how municipal bonds are treated in bankruptcies when deciding on limitations or preconditions to Chapter 9 access.

Municipalities commonly issue two types of municipal bonds—general obligation bonds and special revenue bonds.¹⁴¹ It is important to address the differences between these two types because they are treated differently under Chapter 9 bankruptcies.¹⁴² General obligation bonds are generally paid from tax revenues and are backed by the full faith, credit, and resources of the issuing municipality.¹⁴³ In other words, the bonds are to be repaid by the general taxing power of the municipality and therefore are based on its overall financial strength.¹⁴⁴ On the other hand, a special revenue bond is typically repaid solely from revenues generated by the project or system from which the revenues are derived.¹⁴⁵ For example, a special revenue bondholder whose funds are used to finance a toll road might be repaid only from the finances collected by that toll. Essentially, the revenue sources are pledged as security for the payment of the bonds.¹⁴⁶

Due to their full faith and credit backing, general obligation municipal bonds are typically considered one of the safest categories of investments, second only to securities issued by the United States federal government.¹⁴⁷ However, recent treatment of general obligation bonds in Chapter 9 proceedings threatens to jeopardize this principle.

139. *Id.*

140. *Id.*

141. *What Detroit's Bankruptcy Means for Muni Bonds*, CHARLES SCHWAB ON INVESTING, Winter 2013, available at http://www.schwab.com/public/file/P-6479089/On_Investing_Full_PDF.pdf.

142. NAT'L ASS'N OF BOND LAWYERS, *supra* note 1, at 50.

143. *Id.*

144. Jay Reding, *Municipal Bankruptcies May Force Municipal Bondholders to Accept Haircuts*, LARKIN HOFFMAN ATT'YS, June 29, 2012, http://www.larkinhoffman.com/news/article_detail.cfm?ARTICLE_ID=908&ARTICLE_TYPE_ID=2.

145. Gina Martin, *Payment on Bonds in Chapter 9: Special Revenue vs. General Obligation Part 1 of 2*, GOODWIN PROCTER, Nov. 28, 2012, <http://blog.munibk.com/payment-of-bonds-in-chapter-9-special-revenue-vs-general-obligation-bonds-part-1-of-2>.

146. NAT'L ASS'N OF BOND LAWYERS, *supra* note 1, at 50.

147. *Id.* at 4.

Historically, both types of bonds were treated equally in municipal bankruptcies.¹⁴⁸ However, in 1998, Congress passed “An Act to Amend the Bankruptcy Law to Provide Special Revenue Bonds and for Other Purposes.”¹⁴⁹ The amendments favor special revenue bonds, as they were designed to guarantee that municipalities maintain open access to capital markets by ensuring that dedicated revenues would not be diverted if bankruptcy occurred.¹⁵⁰ In other words, the amendments ensure that pledged special revenue bonds cannot be used for the general obligations of a municipality.¹⁵¹ Rather, under Chapter 9, these bonds retain their lien on the revenue generated by the project and payments are not interrupted by any automatic stay during bankruptcy.¹⁵² Although these protections make special revenue bonds relatively safe, it is important to remember that the bondholders usually have no remedy against the municipality if the project revenues are insufficient to repay the bond debt owed.¹⁵³

Meanwhile, the typically safer general obligation bonds are treated less favorably under Chapter 9 proceedings.¹⁵⁴ Most of these bonds lack a specific, dedicated revenue source.¹⁵⁵ Therefore, when bankruptcy is filed, a court may treat general obligation bonds without a statutory lien as unsecured debt and force their restructuring.¹⁵⁶ Payment on the bonds during bankruptcy is likely to cease.¹⁵⁷

Despite general obligation bond treatment as unsecured debt in Chapter 9, in practice bankrupt debtors have treated these bonds in a variety of ways with little consistency.¹⁵⁸ For example, Orange County, California continued making its debt service payments on general obligation bonds during its bankruptcy in 1994.¹⁵⁹ Although the payments were not required under Chapter 9, Orange County fulfilled its obligations regardless and ultimately paid back the bonds in full in order to stand by its original pledge of full faith

148. Martin, *supra* note 145.

149. *Id.*

150. *Id.*

151. *Id.*

152. *Id.*

153. *Id.*

154. There are, however, exceptions. For instance, in Rhode Island, the legislation specifically placed general obligation bondholders at the front of the line when a municipality files for Chapter 9 bankruptcy. DEJONG & DOUGHERTY, *supra* note 85, at 3.

155. BRENDA OJENDYK, NUVEEN ASSET MGMT., DO MUNICIPAL ISSUERS STILL HAVE A STRONG WILLINGNESS TO PAY GO DEBT? 1 (2013).

156. SPIOTTO, *supra* note 11, at F-4.

157. *Id.*

158. OJENDYK, *supra* note 155, at 1.

159. *Id.*

and credit.¹⁶⁰ Similarly, when Central Falls, Rhode Island filed for bankruptcy in 2011, the city continued to pay debt service on its general obligation bonds due to a new state law making payments to bondholders a priority when in financial distress.¹⁶¹ Other municipalities, however, decide to contravene their full faith and credit promise and instead take advantage of Chapter 9's automatic stay allowance by defaulting on their general obligation bonds.¹⁶² A recent example is Jefferson County, Alabama in 2011.¹⁶³

With fiscal problems mounting and tax revenues falling, municipal bondholders need to be aware of how Chapter 9 bankruptcies can substantially affect their investments. A municipality often possesses the power to reorganize its debts by reducing principal, extending maturity debts, or entirely refinancing the debt.¹⁶⁴ As part of the bankruptcy process, the municipality submits a reorganization plan to the court for approval, and these plans can directly modify its contractual obligations to general obligation bondholders.¹⁶⁵ Thus far, case law has established the principle that under Chapter 9, general obligation bonds do not need to be paid in full for a bankruptcy court to approve the municipality's restructuring plan.¹⁶⁶ As one court put it, "if a municipality were required to pay prepetition bondholders the full amount of their claim with interest . . . and the [debtor] had no ability to impair the bondholder claims over objection, the whole purpose of Chapter 9 would be of little value."¹⁶⁷

Research undertaken by Moody's Investors Service ("Moody's") provides concrete numbers in terms of returns on general obligation bonds from Chapter 9 municipalities. Since 1970, the average recovery for defaulted municipal bonds is nearly eighty cents on the dollar.¹⁶⁸ Of course, filing for bankruptcy does not necessarily make defaults inevitable. Moody's also estimates that bondholders could recover merely 50% of their investments in the Detroit bankruptcy case.¹⁶⁹ This return threatened to be even smaller before Detroit

160. *Id.* at 2.

161. *Id.*

162. *Id.*

163. *Id.*

164. Reding, *supra* note 144.

165. *Id.*

166. *In re Sanitary & Improvement Dist., No. 7*, 98 B.R. 970, 973 (Bankr. D. Neb. 1989); *In re City of Columbus Falls, Montana, Special Improvement Dist., No. 25*, 26, 28, 143 B.R. 750, 760 (D. Mont. 1992) (allowing Chapter 9 debtor to impair general obligation bondholders as long as the other Chapter 9 requirements were satisfied).

167. *In re Sanitary & Improvement Dist., No. 7*, 98 B.R. at 974.

168. Liz Farmer, *Bondholders Losing Ground in City Bankruptcies*, GOVERNING, Oct. 24, 2013, <http://www.governing.com/news/headlines/gov-bondholders-losing-ground-in-muni-bankruptcies.html>.

169. *Id.*

filed for bankruptcy, as Emergency Manager Kevyn Orr proposed paying back just 10% of the city's debt back in June 2013.¹⁷⁰ Now, Detroit's restructuring plan entails higher recoveries for bondholders at the expense of pension cuts.¹⁷¹

In Harrisburg, Pennsylvania, the bankruptcy proposal refunds 60–70% of total defaulted principal for general obligation bonds.¹⁷² However, Moody's notes that ultimate recoveries may be higher if the plan for additional future revenues for creditors is successful, while an ability to execute the plan could reduce recoveries.¹⁷³ The variation in returns is also evidenced by Stockton, California's recent Chapter 9 proposal. There, recovery rates vary between 1% and 100% for bondholders, with its largest creditor slated to recover only 50% of its original investment.¹⁷⁴

VIII. CALL FOR UNIFORMITY AMONG STATES

Twenty-seven states currently fall into one of the three categories that allow municipalities some form of access to bankruptcy relief—"States With Limited Chapter 9 Authorization," "States With Preconditions to Chapter 9 Filings," and "States Providing Unfettered Access to Chapter 9." This section will argue that direct statutory authorization, devoid of limitations or preconditions, best aligns with the goals of uniformity, predictability, and a favorable municipal bond market. The twenty-seven authorizing states and the states that de-authorize or remain silent, therefore, should provide unfettered access to Chapter 9.

Limitations and preconditions afford states autonomy in choosing the steps they desire their municipalities to take when facing financial adversity. This autonomy beneficially accounts for the different characteristics and ideals of each state, particularly in comparison to the unfettered authorization approach. However, the state autonomy does not account for differences between municipalities within a state. In other words, the Chapter 9 limitations and preconditions imposed by a state may represent a strong solution for one of its municipalities but may be an ill-advised approach for another.

Local municipalities inherently understand their financial situation and possible need for Chapter 9 relief more so than states, which often consist of thousands of local governments. For example, in Illinois, it is hard to imagine that any one of the state-imposed limitations or preconditions is truly in the

170. *Id.*

171. *Id.*

172. *Id.*

173. *Id.*

174. Farmer, *supra* note 168.

best interest of all 6,963 of its municipalities.¹⁷⁵ To the contrary, many states mandate preconditions that can be extremely damaging to certain municipalities' attempts at fiscal recovery. Complying with preconditions can be incredibly time-consuming. Not only is time crucial to municipalities in periods of financial distress, but this also represents time that could instead be dedicated to Chapter 9 proceedings and a corresponding readjustment plan. Preconditions can also be costly for municipalities already in financial peril, and these expenses become entirely futile if the municipality ultimately ends up proceeding with Chapter 9 regardless. In fact, states requiring excessive preconditions functionally disallow Chapter 9 access altogether. Meanwhile, unfettered state authorization would support municipality autonomy and avoid many of these time and financial costs.

The local autonomy argument also ties into the principle that unfettered Chapter 9 access is the superior authorization category from a fairness perspective. As one commentator notes, "individuals and corporations can file for bankruptcy by simply signing a few papers and paying the filing fee."¹⁷⁶ In this sense, the United States appears to consider access to bankruptcy relief a fair and fundamental privilege for financially struggling individuals and entities. Why, then, should municipalities be subject to preconditions and limitations before being afforded the chance to benefit from a fresh start in bankruptcy?

In terms of fairness, the previously discussed Illinois limitation seems inherently discriminatory, as it grants and denies § 109(c)(2) specific authorization on the sole basis of population. Is it fair to enact such a limitation that denies certain municipalities access to bankruptcy protection simply because of their considerable size? On the other hand, Missouri's unfettered authorization statute provides the bankruptcy access that is contemplated by fairness considerations in the United States. Authorizing states should avoid implementing preconditions or limitations in response to public and political pressures to prevent municipal bankruptcies.¹⁷⁷ Only unfettered access to Chapter 9 allows municipalities to fairly and autonomously decide whether or not to regain their financial stability through bankruptcy.

It is also worth noting that bankruptcy can be viewed as a last resort for municipalities. States switching to unfettered Chapter 9 filing authorization

175. BRIAN COSTIN, ILL. POL'Y INST., *TOO MUCH GOVERNMENT: ILLINOIS' THOUSANDS OF LOCAL GOVERNMENTS 1* (2013), available at http://illinoispolicy.org/wp-content/files_mf/1384372675Too_much_gov.pdf. Illinois has the most units of local government of any state in the country, followed by Texas at 5,147. *Id.*

176. Warfield, *supra* note 77.

177. For example, Rhode Island enacted preconditions only "in the face of a Chapter 9 filing by Central Falls," one of its municipalities. DEJONG & DOUGHERTY, *supra* note 85, at 3.

would in no way be precluded from offering those services that otherwise would be mandated through preconditions. Similarly, complete Chapter 9 access does not preclude municipalities from first pursuing alternatives to bankruptcy. Examples include revenue solutions, negotiated debt modifications, and judicial receivers.¹⁷⁸ Again, the key is that unfettered Chapter 9 access affords municipalities the discretion to choose the course of action that best suits their unique characteristics and financial situations.

Direct specific authorization is also a beneficial approach in relation to the municipal bond market. On a micro level, the fresh start offered by Chapter 9 bankruptcy allows municipalities to recover financially and, in the long run, better position themselves to both issue new bonds at relatively favorable rates and fulfill their corresponding debt obligations in the future. Although investors may be forced to accept haircuts on their bonds in bankruptcy, the returns could be far worse if the municipality defaulted without Chapter 9. Even more important, municipal bankruptcies are historically rare,¹⁷⁹ thus bondholders should continue to expect full payments on their investments. On a macro level, the uniformity from all authorizing states providing unfettered Chapter 9 access should, in itself, create stability in the market. The miniscule risk of a municipality entering bankruptcy and then providing only partial returns on its bond repayments could even be incorporated into bond prices at issuance as a built-in insurance of sorts. In fact, a recent study found that municipalities in states allowing Chapter 9 access already pay a trivial “bankruptcy risk premium” in relation to their unauthorized counterparts.¹⁸⁰ While both the risk to investors and cost to issuers are relatively low, the chance for recovery that Chapter 9 provides to municipalities cannot be overstated. From a long-term perspective, this will lead to financial stability that benefits municipalities and bondholders alike.

Chapter 9 is a tremendous tool for distressed municipalities with benefits ranging from an automatic stay to limited bankruptcy court involvement. In addition, many of its disadvantages are disputable. For example, although credit ratings may initially fall, they can just as quickly be restored after Chapter 9 proceedings. This was the case for Orange County, which “recovered from its ‘junk’ rating status in fairly short order after its 1996 emergence from bankruptcy, eventually securing ‘AA’ status from the rating

178. NAT’L ASS’N OF BOND LAWYERS, *supra* note 1, at 7–13.

179. Mike Maciag, *How Rare Are Municipal Bankruptcies?*, GOVERNING, Jan. 24, 2013, <http://www.governing.com/blogs/by-the-numbers/municipal-bankruptcy-rate-and-state-law-limitations.html>.

180. Tima T. Moldogaziev, Sharon N. Kioko, & W. Bartley Hildreth, *Bankruptcy Risk Premium in the Municipal Securities Market*, BOND BUYER, available at <http://www.bondbuyer.com/media/pdfs/BBrandeis14-Tima-paper.pdf>.

agencies.”¹⁸¹ Any lingering public perception that bankruptcy is detrimental needs to change, and fortunately Chapter 9 stigma appears to be on the decline.¹⁸² In fact, Warren Buffett recently stated that the stigma “has probably been reduced” in light of the filings by Stockton and San Bernardino.¹⁸³

Finally, the predictability offered by blanket authorization cannot be understated. The statutes are straightforward, easy to interpret, and bring certainty to municipalities and investors alike. On the other hand, preconditions and limitations expose municipalities to the failures of the political process. Politicians might be hesitant to engage in a politically sensitive bankruptcy in spite of the best economic interests of the municipality. Corruption may also play a role. The time has come for states to uniformly grant their municipalities unfettered access to Chapter 9.

IX. CLOSING REMARKS

Regardless of which authorization category is truly in the nation’s best interest, the current variation in approaches among states is alarming. This variation makes it difficult for bondholders, citizens, and even local governments themselves to properly understand the recovery options of financially distressed municipalities. Uniformity, predictability, and a stable municipal bond market should be principal concerns for states.

The outcome of the Detroit case could potentially lead to drastic authorization changes nationwide and may ultimately modify some of this comment’s analysis. However, it bears repeating that the city’s situation is quite unique in the Chapter 9 context. As one commentator put it, “[t]here is really no precedent for a municipality as large, troubled, and complex as Detroit.”¹⁸⁴ Regardless, the public finance industry should certainly follow the remainder of the case and carefully scrutinize the court’s final decisions.

TOM D. HOFFMANN*

181. Barson & Lawall, *supra* note 19, at 12.

182. Liz Farmer, *The ‘B’ Word: Is Municipal Bankruptcy’s Stigma Fading?*, GOVERNING, Mar. 2013, <http://www.governing.com/topics/finance/gov-bword-stigma-municipal-bankruptcy-going-away.html>.

183. Margaret Collins, *Buffett Says Muni Bankruptcies Poised to Climb as Stigma Lifts*, BLOOMBERG (ONLINE), July 13, 2012, <http://www.bloomberg.com/news/2012-07-13/buffett-says-muni-bankruptcies-poised-to-climb-as-stigma-lifts.html>.

184. Warfield, *supra* note 77.

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